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Br2:PSKirwan

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District Counsel, Chicago

Senior Technician Reviewer, Branch 2 CC:IT&A

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This is in response to your memorandum dated October 17, 1990, requesting assistance in connection with the audit of the taxpayer named above. The Associate Chief Counsel (Tax Litigation) has requested that we respond to you directly. Your memorandum requested the views of the national office on the proper treatment of payments made in 1987 by the subject taxpayer in settlement of claims made by former employees under the Age Discrimination in Employment Act, 29 U.S.C. §§621-634 (ADEA). We shall first discuss the issue of whether any amounts received under the ADEA are excludible from the recipient's gross income under section 104(a)(2) of the Code. We shall then discuss the withholding and employment tax consequences of the conclusions reached with respect to section 104(a)(2).

FACTS

The taxpayer, [REDACTED], offered certain employees early retirement. After accepting the offer, several former employees sued the taxpayer under the ADEA. The taxpayer settled the lawsuit for a total payment of \$ [REDACTED] to be divided among the [REDACTED] plaintiffs. The statement of facts in the memorandum from the District Counsel, Chicago, indicates that the settlement amount was composed of lost pay reimbursement claimed by the plaintiffs, along with an equal amount of liquidated damages of the type provided for by the ADEA, as well as unspecified amounts of attorney fees and costs of the action. The taxpayer did not withhold any amount from the settlement, nor did the taxpayer issue either a Form W-2 or a Form 1099 to any of the former employees.

The taxpayer also paid certain amounts to former employees who had initially joined in the suit but withdrew before the settlement. The taxpayer issued Forms 1099 to this class of recipients, but did not withhold any employment taxes or Federal taxes. The plaintiffs to the suit generally did not report the amounts received in their gross income. The former employees who received amounts from the taxpayer generally did report the amounts in their gross income. The Service has been unable to

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determine the exact amount received by any of the former employees.

104(a)(2) ISSUE

I. Statutory and Regulatory Framework

Section 61(a) provides that "[e]xcept as otherwise provided . . . gross income means all income from whatever source derived . . . ."

Section 104(a) provides, in pertinent part, as follows:

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include --

. . . .

(2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness

. . . .

Section 104(a) further provides that "[p]aragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." This portion of section 104(a) was added by section 7641(a) of the Revenue Reconciliation Act of 1989, Pub. L. 101-239, 1990-1 C.B. 210, 255.

Section 1.104-1(c) of the regulations explains the exclusion set forth in section 104(a)(2) as follows:

Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon a tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

## II. Analysis

In enacting the ADEA in 1967, the Congress stated that the purposes of the ADEA were "to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; [and] to help employers and workers find ways of meeting problems arising from the impact of age on employment." Section 2 of Pub. L. 90-202, 81 Stat. 602 (Dec. 15, 1967), 29 USC 621(b). Section 4(a) of the ADEA, 81 Stat 603, 29 USC 623(a) provides that it is unlawful for an employer:

- (1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, condition, or privileges of employment, because of such individual's age;
- (2) to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individuals age; or
- (3) to reduce the wage rate of any employee in order to comply with this chapter.

Section 7(b) of the ADEA, 81 Stat. 604, 29 USC 626(b), provides that the rights created by the ADEA are to be "enforced in accordance with the powers, remedies, and procedures" of the FLSA. Under the FLSA, any employer who violates the provisions of that act is "liable to the employee or employees affected in the amount of their unpaid wages, or their unpaid overtime compensation . . . and in an additional equal amount as liquidated damages." It seems clear that the statutory, non-liquidated portion of the damages available under the ADEA, through the enforcement provisions of the FLSA, constitute wages, or back pay, and are thus not excludible from gross income. Cf., Thompson v. Commissioner, 866 F.2d 709 (4th Cir. 1989), aff'g, 89 T.C. 632 (1987) (statutory damages received under the Equal Pay Act and Title VII of the Civil Rights Act of 1964 constitute back pay and are not excludible from gross income). Thus, all amounts properly classifiable as non-liquidated damages received under the ADEA are includible in the gross incomes of the recipients.

However, regarding liquidated damages, the ADEA did not merely incorporate the FLSA's penalty provisions. Rather, it

adopted a higher threshold for receiving liquidated damages than that used in the FLSA.

Liquidated damages under the FLSA are provided for in section 16(b) of that Act, 52 Stat. 1069, 29 USC 216(b). An employer can avoid paying liquidated damages only by showing, to the satisfaction of the court, that the act or omission giving rise to the claim under the FLSA was in good faith and that the employer had reasonable grounds for believing that his act or omission was not a violation of the FLSA. 29 USC 260.<sup>1</sup> Even with such a showing, the court may, in its discretion, award liquidated damages. Thus, the Congress has adopted a legislative scheme which favors granting liquidated damages to a successful FLSA plaintiff.

Thompson v. Commissioner, 89 T.C. 632(1987), aff'd, 866 F.2d 709 (4th Cir. 1989), involved the includability in gross income of an award under the liquidated damages provision of the FLSA, 29 USC 216(b).<sup>2</sup> The Tax Court held that the liquidated damages received as a result of sex discrimination were damages for personal injury and thus were within the terms of section 104(a)(2), which allows exclusion from gross income of amounts received on account of injury or sickness. As set forth below, the ADEA liquidated damages are awarded under a different statutory provision than FLSA liquidated damages, with a different standard and a different purpose.

In contrast to the FLSA, the ADEA, at section 7(b), provides that "liquidated damages shall be payable only in cases of willful violations of [the ADEA] ...." 29 USC 626(b). A violation is "willful" only if the employer either knew or showed reckless disregard for the matter of whether its conduct was prohibited by the ADEA. Trans World Airlines v. Thurston, 469 U.S. 111, 128(1985). The plaintiff has the burden of proving willfulness. Blackwell v. Sun Electric Corporation, 696 F.2d 1176 (6th Cir. 1983). Thus, under the ADEA, a plaintiff must prove that the defendant either (1) knew that its conduct was prohibited by the ADEA, or (2) showed reckless disregard for whether its conduct

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<sup>1</sup>Section 260 was enacted as section 11 of the Portal-To-Portal Act of 1947, 61 Stat. 89 (May 14, 1947).

<sup>2</sup>The award in Thompson was for a violation of Title VII of the Civil Rights Act of 1964, 42 USC 2000e, et seq., and the Equal Pay Act of 1963, 29 USC 206(d). Damages under the Equal Pay Act are determined under 29 USC 216(b) of the FLSA.

was prohibited by the ADEA. This is a different standard than that used under the FLSA, which provides for the payment of liquidated damages unless the defendant can prove that he acted in good faith. See Lindsey v. American Cast Iron Pipe Co., 810 F.2d 1094, 1102 (11th Cir. 1987), where the court stated:

Liquidated damages under the ADEA are different in kind from those available under the FLSA. ADEA liquidated damages awards punish and deter violators, while FLSA liquidated damages merely compensate for damages that would be difficult to calculate. [Footnote omitted.]

In summary, the FLSA provides a low threshold for assessing liquidated damages to a person who has been paid less than the statutory minimum. By contrast, in the ADEA, Congress is trying to prevent arbitrary age discrimination and promote employment of older persons. Under the ADEA, the plaintiff must prove that the defendant acted in bad faith in order to receive liquidated damages. In our view, under the ADEA, because liquidated damages are not assumed but must be proven, and because there is no statutory presumption of injury as under the FLSA, liquidated damages are purely punitive.

Punitive damages are not excludible from gross income under section 104(a)(2) of the Code. Miller v. Commissioner, 914 F.2d 588 (4th Cir. 1990), rev'g, 93 T.C. 330 (1989); But see, Burford v. Commissioner, 642 F. Supp. 635 (N.D. Ala. 1986). We believe that the Miller case was correctly decided.<sup>3</sup> Thus we believe that liquidated damages received under the ADEA, inasmuch as they are punitive in character, are not excludible from the gross income of the recipients.

In summary, that portion of any amount received under the ADEA that represents back pay, front pay, or lost pension benefits should be treated as wages. In our view, liquidated damages paid under the ADEA are punitive in nature and are therefore also includible in income, but are not considered wages.

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<sup>3</sup> For amounts received due to cases filed or settlements reached after July 10, 1989, the recent amendment to section 104(a) specifically states that punitive damages received in cases not involving physical injuries or sickness are not excludible. Section 7641(b)(2) of the Revenue Reconciliation Act of 1989, Pub. L. 101-239, 1990-1 C.B. 210, 255.

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This position should be compared to the approach taken by the Third Circuit in the case of Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990), aff'g in part and rev'g in part, 92 T.C. 510 (1989). In Rickel, the taxpayer received an award under the ADEA which was composed of both back pay and liquidated damages. The Tax Court held that the back pay portion of the award to Mr. Rickel was includible in his income, but the liquidated damages portion was excludible under section 104(a)(2) of the Code. The taxpayer appealed, and the Third Circuit reversed part of the Tax Court's opinion and held that the back pay portion of the award was also excludible from the taxpayer's income. Subsequently, we have also lost this issue in Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990). The Service does not follow these cases outside of the third and sixth circuits. The taxpayer here is located in the Seventh Circuit, but the correct treatment of the amounts paid should be determined by reference to the residence of the recipients. Thus, although we believe that all amounts paid under the ADEA are includible in the gross incomes of the recipients, we should not force the taxpayer to withhold income tax, FICA, or FUTA from individuals residing in either the third or sixth circuits. We are continuing to litigate these issues in all other forums. Thus, if an individual resides anywhere outside of the third or sixth circuits, all amounts paid under the ADEA are includible in their gross income, and the employer must withhold as set forth below.

#### EMPLOYMENT TAX ISSUE

Both the employee and the employer are responsible for the Federal Insurance Contributions Act (FICA) taxes. Section 3102 of the Code states that the employer is required to collect the tax by way of a deduction from wages "as and when paid" and becomes liable for the payment at that time. Section 31.3101-3 of the Employment Tax Regulations provides that the employee portion of the tax attaches when the employee receives the wages and section 31.3101-2(c) of the regulations requires that the tax be computed by application of the rates in effect at the time such wages are received. Section 3111 of the Code imposes the employer portion of the tax on wages paid with respect to employment.

An employer's obligation to withhold from its employees' wages and to pay withholding taxes is set forth in sections 3402 and 3403 of the Code and the applicable regulations. Section 3402(a) requires that every employer making a payment of wages deduct and withhold from such wages a tax determined in accordance with tables prescribed by the Secretary. The tax is col-

lected as and when the wages are paid. See, section 31.3402(a)-1 of the regulations.

Section 3401(d)(1) of the Code provides that the term "employer," for purposes of income tax withholding, means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person except that if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of the definition of wages) means the person having control of the payment of such wages.

In Rev. Rul. 72-341, 1972-2 CB 32, employees received certain amounts in settlement of an employment discrimination suit against the employer under Title VII of the Civil Rights Act of 1964, 42 U.S.C. 2000e-2. The amounts were based on the difference between an employee's actual earnings and the earnings that would have been received if there had been no discrimination. Rev. Rul. 72-341 holds that, because the amounts represent compensation that the employees would otherwise have received, the amounts are includible in gross income as compensation and are wages for purposes of FICA and income tax withholding.

Rev. Rul. 78-176, 1978-1 CB 303, considered the employment tax status of amounts recovered from a company under Title VII by individuals who were never employed by the company. The amount paid to each individual represented the agreed amount to compensate for the loss of prospective employment. The ruling concludes that the payments made by the Company are wages for employment tax purposes because compensatory payments made under Title VII are intended to make the victim whole; thus complete reparation would include the wage credits under the Social Security Act.

As we stated above, both the liquidated and the non-liquidated portions of the payments made under ADEA are includible in the gross income of the recipients under section 61 of the Code. However, only the nonliquidated, or lost pay portion of the award is treated as wages and is subject to income tax withholding under section 3402 and FICA taxes under section 3102. The liquidated portion of an award is not considered wages for federal employment tax purposes. See, Rev. Rul. 72-268, 1972-1 C.B. 313; Rev. Rul. 80-364, 1980-2 C.B. 294. That portion of the settlement representing liquidated damages should be reported to the Service on a Form 1099-MISC.

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When a section 3401(d) "employer" does not cooperate in determining what amounts are subject to withholding, the Service is to make a best faith effort, under the circumstance, in making that determination. The burden is then placed on the "employer" to show that the Service's determination is erroneous. Under the facts of this case, the division of the total award by the number of former employees who were a party to the lawsuit appears to satisfy the best faith standard.

If you have any additional questions concerning this issue, please call Patrick S. Kirwan, at FTS 566-6450.

By (signed) Neal E. Sheldon  
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Senior Technician Reviewer,  
Branch 2